Name ______________________ Date ______________________ Class ______________________

STUDY GUIDE Chapter 12, Section 1

For use with textbook pages 313–316

SAVINGS AND THE FINANCIAL SYSTEM

KEY TERMS

saving Not spending; equals disposable income (after tax) minus spending on consumption *(page 313)*

savings The dollars that become available in the absence of consumption *(page 313)*

financial system Network of savers, investors, and financial institutions that work together to transfer savings to investors *(page 314)*

certificate of deposit Receipt showing that an investor has made an interest-bearing loan to a bank *(page 314)*

financial assets Claims on the property and the income of a borrower *(page 314)*

financial intermediaries Financial institutions that bring together the funds that savers provide and lend them to others *(page 314)*

nonbank financial institutions Nondepository institutions that channel savings to borrowers *(page 315)*

finance company Firm that makes loans directly to consumers and specializes in buying installment contracts from merchants who sell goods on credit *(page 315)*

bill consolidation loan Loan used by consumers to pay off other bills *(page 315)*

premium The price the insured person pays regularly for an insurance policy *(page 315)*

mutual fund A company that sells stock in itself to individual investors and then invests the money it receives in stocks and bonds issued by other corporations *(page 316)*

net asset value (NAV) The net value of the mutual fund divided by the number of shares issued by the mutual fund *(page 316)*

pension A regular payment intended to provide income security to someone who has worked a certain number of years, reached a certain age, or suffered a certain kind of injury *(page 316)*

pension fund A fund set up to collect income and disburse payments to those persons eligible for retirement, old-age, or disability benefits *(page 316)*

real estate investment trust (REIT) A company organized primarily to make loans to companies that build homes *(page 316)*

DRAWING FROM EXPERIENCE

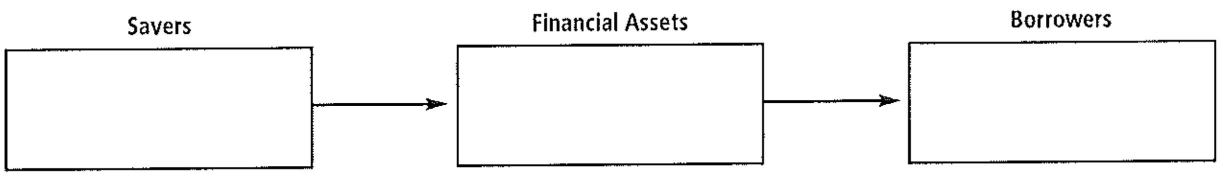
What would you do if you wanted to buy a car? Start your own business? How would you get the money in order to do it?

This section focuses on the importance of savings in the economy.

Name ______________________ Date __________________ Class ______________________

ORGANIZING YOUR THOUGHTS

Use the flowchart below to help you take notes as you read the summaries that follow. Think about the ways in which savings move from savers to borrowers.



READ TO LEARN

Introduction *(page 313)*

To an economist, ***saving*** is *not* spending. ***Savings*** are the money that people have left over after they buy things. In an economic system, the savings of some people are needed to provide money for other uses.

1. What is the source of savings?

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Saving and Capital Formation *(page 313)*

The money that people save in banks can be used by other people who borrow the money. Businesses borrow saved money for many purposes. They use it to provide goods and services, build new plants, and create new jobs. Without savings, no capital would be available.

2. Why are savings necessary for an economy to grow?

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Financial Assests and the Financial System *(page 314)*

A ***financial system*** provides a way of moving funds among savers, investors, and financial institutions. People can save by putting money in savings accounts or investing in bonds.They can also buy a ***certificate of deposit,*** which is a receipt showing that a person has made a loan to a bank. The receipt or document investors get in return for their savings is a ***financial asset.*** It is proof that a person lent money to the bank that borrowed it.

Different kinds of financial institutions act as financial intermediaries. ***Financial intermediaries*** are financial institutions that move savers' extra funds to the borrowers who need them. Some financial intermediaries, such as banks, are institutions in which savers deposit money. Savers can also provide funds directly to borrowers. Borrowers produce financial assets that they then use to repay the people who lent them money. Households and businesses are the most important savers. Governments and businesses are the largest borrowers.

The overall pattern of saving and borrowing is something like a circle in which money is transferred from a saver to a borrower and is then paid back to the saver. The circle begins when a saver deposits money in an institution such as a bank. Then the bank lends the money to a borrower. The borrower repays the loan with interest. The circle is completed when the saver collects interest on the money he or she saved.

3. Describe the circular flow of funds in the economy.

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Nonbank Financial Intermediaries *(page 315)*

Banks are depository institutions because savers deposit their money, and the banks then lend their depositors' savings. Savings are also lent to borrowers by different kinds of ***nonbank financial institutions.*** There are different types of nonbank finanical institutions.

A. ***Finance companies*** make loans to consumers and take over the loans that stores make to consumers who buy items on credit. Finance companies also offer bill consolidation loans. A ***bill consolidation loan*** consists of a loan that allows a person to pay a lot of different bills at the same time. Because finance companies make riskier loans, they generally charge higher interest than banks.

B. People buy life insurance to make sure that their families are protected financially. If the people die, their families collect money from the life insurance companies. To pay for the life insurance, policy holders make cash payments, called ***premiums.*** Life insurance companies then use this cash to make loans to banks or finance companies.

C. A ***mutual fund*** is a company that invests in a variety of stocks or bonds. The company then sells shares of stock in the mutual fund to investors. Owners of mutual funds receive dividends and can sell their shares. Mutual funds allow investors to invest in a lot of different stocks at the same time. To figure the ***net asset value (NAV)*** of a mutual fund, you divide the net value of the fund by the number of shares in the fund.

D. A ***pension fund*** collects money from workers and invests it. When workers reach a certain age, retire, or are disabled, they collect regular ***pension*** payments from the fund.

E. A ***real estate investment trust (REIT)*** provides loans mainly for home construction. Such trusts borrow from banks, then collect income from rents and mortgage payments.

4. What are three kinds of nonbank financial institutions?

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Name ______________________ Date ______________ Class ______________________

STUDY GUIDE Chapter 12, Section 2

For use with textbook pages 318–326

INVESTMENT STRATEGIES AND FINANCIAL ASSETS

KEY TERMS

risk A situation in which the outcome is not certain, but the probabilities of different outcomes can be estimated *(page 318)*

401(k) plan Tax-deferred investment and savings plan that acts as a personal pension fund for employees *(page 320)*

coupon Stated interest on a debt *(page 321)*

maturity The life of a bond *(page 321)*

par value Principal or the total amount initially borrowed that must be repaid to the lender at maturity *(page 321)*

current yield The annual interest on a bond divided by its purchase price *(page 321)*

municipal bonds Bonds issued by state and local governments *(page 323)*

tax-exempt The federal government does not tax the interest paid to investors *(page 323)*

savings bonds Low-denomination, nontransferrable bonds issued by the United States government *(page 323)*

Treasury notes U.S. government obligations with maturities of two to 10 years *(page 324)*

Treasury bonds U.S. government bonds that have maturities ranging from more than 10 to as many as 30 years *(page 324)*

Treasury bill (T-Bill) Short-term U.S. government obligation with a maturity of 13, 26, or 52 weeks and a minimum denomination of $10,000 *(page 324)*

Individual Retirement Accounts (IRAs) Long-term tax-sheltered time deposits that an employee can set up as part of a retirement plan *(page 324)*

Roth IRA An IRA whose contributions are made after taxes so that no taxes are taken out at maturity *(page 325)*

capital market Market where money is loaned for more than one year *(page 325)*

money market Market where money is loaned for periods of less than one year *(page 325)*

primary market Market where only the original issuer can repurchase or redeem a financial asset *(page 326)*

secondary market Market in which existing financial assets can be resold to new owners *(page 326)*

STUDY GUIDE (continued) Chapter 12, Section 2

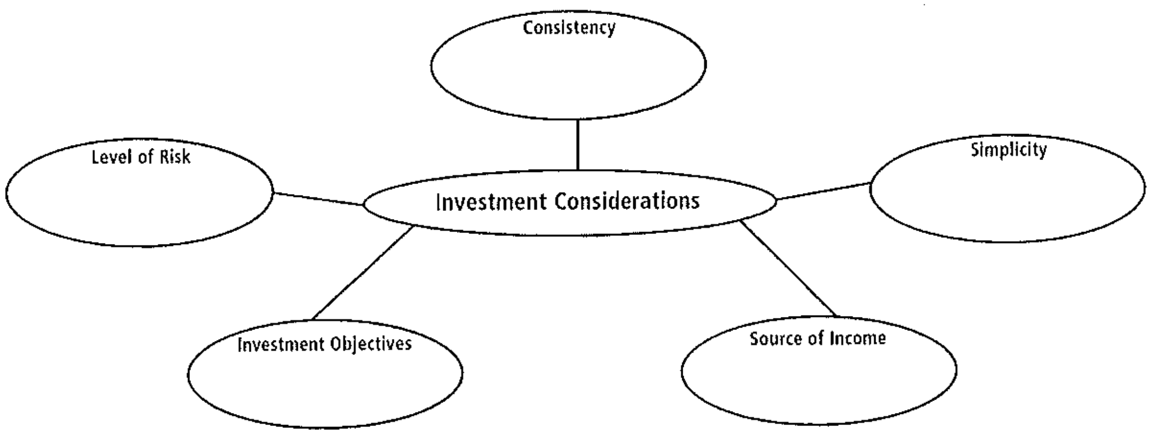
DRAWING FROM EXPERIENCE

Are you willing to take chances? Or are you cautious and careful when making choices? Personality traits often influence the type of financial decisions a person makes.

In the last section, you learned about how savings are transferred to investors. This section focuses on the many different kinds of financial assets that are available to investors.

ORGANIZING YOUR THOUGHTS

Use the diagram below to help you take notes as you read the summaries that follow. Think about how the stock market operates and the role of investors' decisions.



READ TO LEARN

■ Basic Investment Considerations *(page 318)*

There are several factors to think about when investing in financial assets:

A. ***Relationship between risk and return*** Different investments carry a different level of ***risk,*** or the degree to which the investor cannot predict how well the investment will do. Investors sometimes choose risky investments if those investments may give a higher return (earn more money) than less risky investments.

B. ***Personal investment goals*** A person must think about why he or she is investing the money. A person should also think about how much money he or she can afford to invest.

C. ***Consistency of investment*** Successful investors usually choose a consistent strategy—that is, a strategy that is basically the same over a long period of time. It is better to save a little bit each month than to expect to save one large amount of money several years from now.

D. ***Simplicity*** Successful investors know that it is important to understand the investments they choose.

The 401(k) plan is a popular employees' program for saving money that acts as a pension fund. The money is subtracted from the worker's pay and invested in some way. In most cases, employers also contribute some money to the 401(k) investments. The employee does not have to pay taxes on the money in the 401(k) until he or she takes the money out of the investment.

1. What factors should an investor consider in choosing a financial asset?

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Bonds as Financial Assets *(page 320)*

Bonds are long-term loans taken out by companies or governments. They pay a specific interest regularly for a certain number of years. A bond's three parts include:

A. the stated interest on the debt, or ***coupon.*** This is the interest that the borrower pays to the investor.

B. the term or number of years that the money is invested, which is called the bond's ***maturity.***

C. the principal, or the original amount loaned—the ***par value.***

When a bond reaches maturity, the company repays the par value. Meanwhile, the bond also pays interest.

Supply and demand determine the price of a bond. Investors can look at the bond's ***current yield*** (annual interest divided by purchase price). They can also look at the financial health of the corporation or government issuing the bond.

2. What factors determine the price of a bond?

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Bond Ratings *(page 321)*

Two companies, Moody's and Standard & Poor's, issue ratings of bond quality. The best rating is AAA. Bonds with higher ratings sell at higher prices, while lower-rated (and riskier) bonds may have a higher current yield.

3. What two companies rate bond quality?

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Financial Assets and Their Characteristics *(page 322)*

The different kinds of financial assets available vary in cost and risk.

A. ***Certificates of deposit*** A CD (certificate of deposit) is not a bank account but a loan the investor makes to a financial institution. CDs can be for small amounts. Investors can choose the length of maturity. Most CDs are insured.

B. ***Corporate bonds*** Large companies sell bonds as well as stock. Bond prices are affected by supply and demand—the more bonds that are sold, the higher the price that the lender will charge. Bond prices are also based on risk and ratings. Some bonds are risky investments, because the seller may not be able to pay back the loan. Junk bonds are very risky bonds but usually pay high interest.

C. ***Municipal bonds*** State and local governments issue ***municipal bonds*** ("munis") to pay for projects such as roads or new schools. Municipal bonds are safe investments. They are generally ***tax-exempt.*** This means that they are not subject to federal taxes or, sometimes, to state taxes.

D. ***Government savings bonds*** The U.S. government sells ***savings bonds*** with different values, from $50 to $10,000. Savings bonds also have different maturities (length of investment period) and pay different amounts of interest. The buyer buys at a discount, paying less than the full value. The buyer then receives the interest when the bond's period of investment ends.

E. ***Treasury notes and bonds*** The federal government also issues ***Treasury notes,*** with maturities up to 10 years, and ***Treasury bonds,*** with maturities of 10 years to over 30 years. Because they are backed by the government, they are very safe. However, they have the lowest returns of any assets. They come in values of $1,000 and $5,000.

F. ***Treasury bills (T-bills)*** T-bills are another form of government borrowing. They are short-term investments. They have maturities up to one year and a minimum denomination of $10,000.

G. ***Individual Retirement Accounts (IRAs)*** To save money that they can use when they are older and retire (stop working), many workers set up ***Individual Retirement Accounts,*** or ***IRAs.*** IRA deposits up to $2,000 can be subtracted from taxable income each year, so that the person does not pay income tax on this money. The person pays the taxes much later, when he or she takes the money out of the IRA. A ***Roth IRA*** is somewhat different. When people put money into a Roth IRA, they pay income taxes on that money. However, they do not have to pay taxes on money that they later take out of the IRA.

4. What are four types of financial assets issued by the federal government? If you had $500 to invest, which one would you buy?

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☐ Markets for Financial Assets *(page 325)*

Investors classify markets in various ways. These markets are not really separate. One market may be part of another one.

One difference in markets is based on the length of time for which money is lent. Investment loans with lengths of more than one year, such as long-term CDs, are traded in the ***capital market.*** A ***money market*** is the term for a market in which investments are lent to the borrower for less than one year. Investments that can only be bought back by the original borrower are part of the ***primary market.*** Government savings bonds are one example. Investments that are likely to be resold to another owner are in the ***secondary market.***

5. If you own a corporate bond with a maturity of 10 years, are you taking part in the capital market or the money market? Explain.

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Name ______________________ Date ________________ Class ______________________

STUDY GUIDE Chapter 12, Section 3

For use with textbook pages 328–333

INVESTING IN EQUITIES, FUTURES, AND OPTIONS

KEY TERMS

equities Stocks that represent ownership shares in a corporation *(page 328)*

Efficient Market Hypothesis (EMH) Argument that stocks are always priced about right and that bargains are hard to find because they are followed closely by so many investors *(page 329)*

portfolio diversification The practice of holding a large number of stocks so that increases in some can offset unexpected declines in others *(page 329)*

stockbroker Person who buys or sells equities *(page 329)*

securities exchanges Places where buyers and sellers meet to trade securities *(page 329)*

seats Memberships in the New York Stock Exchange that allow access to the trading floor *(page 330)*

over-the-counter market (OTC) Electronic marketplace for securities not traded on an organized exchange *(page 331)*

Dow-Jones Industrial Average (DJIA) The most popular and widely publicized measure of stock market performance on the New York Stock Exchange *(page 332)*

Standard & Poor's 500 (S&P 500) Popular measure of stock market performance based on price changes of 500 representative stocks *(page 332)*

bull market A "strong" market with the prices of equities moving up for several months or years in a row *(page 332)*

bear market A "mean" market with the prices of equities moving sharply down for several months or years in a row *(page 332)*

spot market Market in which transactions are made immediately at the prevailing price *(page 332)*

futures contract An agreement to buy or sell at a specific date in the future at a predetermined price *(page 333)*

futures markets Marketplaces in which futures contracts, or futures, are bought and sold *(page 333)*

options Contracts that provide the right to purchase or sell commodities and/or financial assets at some point in the future at a price agreed upon today *(page 333)*

call option The right to buy a share of stock at a specified price some time in the future *(page 333)*

put option The right to sell a share of stock at a specified price in the future *(page 333)*

options market Market in which options are traded *(page 333)*

DRAWING FROM EXPERIENCE

If you could buy shares of a stock, what companies would you invest in? Why would you choose those companies?

In the last section, you learned about the things that investors should consider when they choose investments. This section focuses on equities, which are one kind of investment.

ORGANIZING YOUR THOUGHTS

Use the chart below to help you take notes as you read the summaries that follow. Think about the relationship between organized stock exchanges and the over-the-counter market.

Organized Stock Exchanges	Over-The-Counter Market

READ TO LEARN

▣ Introduction *(page 328)*

When investors buy ***equities,*** they are buying shares of stock in a corporation. While financial assets represent loans to a company or institution, equities represent part ownership of a company. People can now find information about equities on the Internet. This information helps people make investment choices.

1. What are equities?

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▣ Market Efficiency *(page 328)*

The price of equities is influenced by several factors. For example, if a company is making a good profit, its equities will probably sell at a higher price than if it were losing money. If a company is growing, its stock will probably have a high price. Many market experts believe in the ***Efficient Market Hypothesis.*** It states that there are many well-informed investors and people who analyze the stock market. The actions of these people, such as choosing investments and writing about them, keep the price of stocks at about the value that they should be at. In this market, portfolio diversification is important. ***Portfolio diversification*** consists in investing in a lot of different stocks, rather than investing most of your money in just a few stocks.

Investors can buy equities through a ***stockbroker,*** or a person who buys and sells stocks at a stock exchange. Investors can also use their computers to open an Internet trading account.

2. What is the Efficient Market Hypothesis?

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Organized Stock Exchanges *(page 329)*

Buyers and sellers make stock trades in different organized securities exchanges. A ***securities exchange*** is a place where stocks are bought and sold.
There are different types of stock exchanges:

A. ***New York Stock Exchange*** The New York Stock Exchange (NYSE) is the oldest and most famous stock exchange. It lists stocks of about 2,800 carefully selected companies. In order for a stockbroker to trade on the NYSE, he or she needs a membership, or ***seat.***

B. ***American Stock Exchange*** The American Stock Exchange (AMEX) is also located in New York City. It lists about 750 stocks. Companies that trade on this exchange are usually smaller than those that trade on the New York Stock Exchange.

C. ***Regional stock exchanges*** Other major cities in the United States have stock exchanges that list smaller regional companies as well as national corporations.

D. ***Global stock exchanges*** Major cities in Europe, Asia, Africa, and Australia have stock exchanges. Computers link stock exchanges all around the world. Because of this, stocks can be traded all over the world, 24 hours a day.

3. How do you think technology and the Internet have influenced trading among worldwide exchanges?

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The Over-the-Counter Market *(page 331)*

Most stocks in the United States are traded electronically on the ***over-the-counter market (OTC).*** Unlike the organized stock exchanges, the OTC market is not limited to a single trading location. The most important OTC market is the National Association of Securities Dealers Automated Quotation, or NASDAQ, which lists the stock prices and activities of over 4,000 companies. When an investor places an order with a broker, it may go to a major exchange or to the OTC.

4. How is the OTC market different from NYSE and AMEX?

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STUDY GUIDE (continued) Chapter 12, Section 3

Measures of Stock Performance *(page 332)*

Investors have two main ways of knowing how the market is doing:

A. ***Dow-Jones Industrial Average (DJIA)*** The Dow-Jones is the best-known measure of stock performance. It is based on 30 stocks on the NYSE. The stocks in the sample have changed over time.

B. ***Standard & Poor's 500 (S&P 500)*** To show how the whole market is doing, the S&P 500 uses the price changes in 500 stocks from the NYSE, AMEX, and OTC markets.

Overall market performance is described in two ways. In a ***bull market,*** stock prices are rising steadily over time. In a ***bear market,*** stock prices move sharply downward over time.

5. Suppose you have just bought your first share of stock. Which kind of market do you hope for—bear or bull? Why?

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Trading in the Future *(page 332)*

Some stock transactions are based on estimates of future performance. They take place in different markets. Immediate transactions at today's price take place in the ***spot market.*** Others take place in the ***futures market.*** There, investors buy and sell futures contracts. With a ***futures contract,*** a buyer agrees to buy a certain amount at a certain price on a specified future date. Futures contracts often involve investing in grain and farm animals.

Like futures, ***options*** deal with buying or selling in the future. They are traded in ***options markets.*** However, unlike futures, they provide the right to buy or sell, not an obligation to do so. A ***call option*** is the right to buy stock at a specified price in the future. A ***put option*** is the right to sell a stock at a specified price in the future.

6. What is the main difference between options and futures contracts?

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